

PHILLIPS PETROLEUM CO.

IBLA 88-552

Decided January 10, 1990

Appeal from a decision of the Director, Minerals Management Service, denying appeal from a letter of the Regional Manager, Tulsa Regional Compliance Office, Royalty Management Program, Minerals Management Service, directing the recalculation of royalties owed on natural gas liquid production. MMS-86-0261-OCS.

Affirmed in part, set aside in part, and remanded.

1. Federal Oil and Gas Royalty Management Act of 1982: Royalties--Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Outer Continental Shelf Lands Act: Oil and Gas Leases

MMS' Procedure Paper concerning valuation of NGLP for royalty purposes was not required to be promulgated as a regulation because it does not constitute a substantive rule of law, as it neither creates law nor changes established policy. Rather, it simply clarifies the methodology for applying the factors set forth in 30 CFR 206.150 (1985), providing internal guidance for how this authority should be exercised.

2. Appeals: Generally--Board of Land Appeals--Federal Oil and Gas Royalty Management Act of 1982: Royalties--Minerals Management Service: Generally--Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Outer Continental Shelf Lands Act: Oil and Gas Leases

The interpretation announced by MMS in its Procedure Paper concerning valuation of NGLP did not constitute a sudden change in policy such that its application violated appellant's due process rights and was arbitrary and capricious.

3. Federal Oil and Gas Royalty Management Act of 1982: Royalties--Minerals Management Service: Generally--Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Outer Continental Shelf Lands Act: Oil and Gas Leases

When MMS adopts an agency-wide interpretation that is reasonable and consistent with the law, the Board

will affirm application of that interpretation. MMS' Procedure Paper concerning valuation of NGLP comports with 30 CFR 206.150 (1985) and MMS' reliance on it does not render its actions arbitrary and capricious.

4. Federal Oil and Gas Royalty Management Act of 1982: Royalties--Minerals Management Service: Generally--Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Outer Continental Shelf Lands Act: Oil and Gas Leases

Where the Department's regulations gave fair notice that royalty was due on NGLP, and in the absence of any well-established practice at odds with that announced in a Procedure Paper concerning valuation of NGLP at the time a party paid the royalties on NGLP, there is no bar to retroactive application of the Procedure Paper.

5. Federal Oil and Gas Royalty Management Act of 1982: Royalties--Minerals Management Service: Generally--Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Outer Continental Shelf Lands Act: Oil and Gas Leases

Where a party fails to provide an offer of proof regarding arm's-length contracts for NGLP in effect during the period at issue comparing its contract with the characteristics of arm's-length contracts, the yardstick price is properly applied in lieu of the non-arm's-length contract price. The contract price, even if applied, is subject to correction to remove impermissible deductions for manufacturing costs and location differential.

6. Federal Oil and Gas Royalty Management Act of 1982: Royalties--Minerals Management Service: Generally--Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Outer Continental Shelf Lands Act: Oil and Gas Leases

In valuing NGLP for royalty computation purposes, where the NGLP was sold under a non-arm's-length contract not shown to be comparable to arm's-length contracts that represent market value, MMS may properly use published spot market prices to establish value. However, the Board will set aside an MMS decision instructing a lessee (where the reported price falls below the lowest spot market price) to use the average spot market price instead of the lowest spot market price.

APPEARANCES: T. L. Cubbage II, Esq., Phillips Petroleum Company, for appellant; Peter J. Schaumberg, Esq., Geoffrey Heath, Esq., and Howard W. Chalker, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE HUGHES

The Phillips Petroleum Company (Phillips) has appealed from a decision of the Director, Minerals Management Service (MMS), dated April 19, 1988, denying its appeal from an April 17, 1986, letter of the Regional Manager, Tulsa Regional Compliance Office, Royalty Management Program, MMS, directing it to recalculate royalties owed with respect to certain natural gas liquid products (NGLP).

In his April 1986 letter, the Regional Manager required Phillips, which had acquired Aminoil, Inc. (Aminoil), to recalculate Aminoil's share of royalties owed on NGLP processed from natural gas produced from eight Outer Continental Shelf (OCS) oil and gas leases. ^{1/} The leases are situated off the coast of Louisiana, and the NGLP was processed at the North Terrebonne gas processing plant from January 1984 through April 1986. The Regional Manager directed Phillips to abide by the criteria set forth in his January 28, 1986, letter to Phillips concerning NGLP produced from 1977 through 1983 and required it to submit its review of royalty computations, along with calculations of any additional royalties due, no later than June 10, 1986. Phillips timely appealed to the Director, MMS.

The record contains a copy of the Regional Manager's January 1986 letter informing Phillips that, based on an audit performed by the Office of Inspector General (OIG), U.S. Department of the Interior, and MMS' own review, MMS had made a preliminary determination that Aminoil had underpaid royalties with respect to NGLP derived from processing the natural gas produced from the subject OCS leases from January 1980 through December 1983. The Regional Manager requested Phillips to indicate whether or not it concurred with this determination by February 14, 1986.

The Regional Manager indicated that Aminoil had improperly used "intracompany" transfer prices for NGLP, viz., the prices paid by Aminoil Marketing, Inc. (AMI), which was 50 percent owned by Aminoil:

For determining the reasonableness of the NGLP values for royalty purposes, the OIG utilized procedures established in the MMS "Procedure Paper on Natural Gas Liquid Products Valuation [(Procedure Paper)]." * * * The procedures provide that if disposition of the NGLP was made under non-arm's-length transactions, including transfers to affiliates, the unit values will be compared to the lowest price published in commercial bulletins. If the value falls below the low price, it is considered unreasonable and

^{1/} In its statement of reasons for appeal (SOR) at page 2, footnote 1, Phillips explains that it acquired Aminoil in 1984 and that Aminoil's interest had been transferred to it as of Jan. 1, 1985.

unacceptable and an average value is calculated for use. Accordingly, in the months that the value fell below the low price, the OIG calculated an average value using Mont Belvieu prices.

The Regional Manager concluded that MMS agreed with OIG's finding.

In his April 1988 decision, the Director denied Phillips' appeal from the Regional Manager's April 1986 letter, considering all of the grounds asserted for overturning that letter. Phillips (appellant) appealed to the Board from the Director's April 1988 decision.

In its SOR, appellant challenges only MMS' application of the Procedure Paper, on both a procedural and substantive basis. The Procedure Paper was prepared by the Royalty Valuation and Standards Division of the Royalty Compliance Division, MMS, on December 14, 1984, and revised on February 25, 1985. It was intended to devise a "yardstick" method for determining the reasonableness of the NGLP prices adopted by Federal oil and gas lessees for valuation purposes (Procedure Paper at 3). MMS studied sales contracts, prices received by lessees, regulated prices, and commercial price bulletins, concluding that price bulletins are the "best available price source and in most instances are indicative of NGLP fair market value." Id. at 5. Accordingly, MMS decided to rely on the prices reported in such bulletins as a basis for judging the reasonableness of the NGLP prices adopted by lessees for royalty valuation.

The yardstick selected by MMS was the range between the highest and lowest published prices for the month in which the NGLP to be valued was produced. In addition, depending on the area from which production occurred, the Procedure Paper provides a suggested location of NGLP prices upon which to base the yardstick and recommends a specific commercial price bulletin where such prices could be found for particular time periods. Id. at 6. In the case of production occurring in the Gulf of Mexico, the suggested location is Mont Belvieu, Texas. 2/

The Procedure Paper also generally set forth the method for employing the yardstick, stating that the NGLP prices adopted by lessees would be compared to the highest and lowest published prices for the relevant month from the appropriate bulletin:

If the reported price falls within this range, the value will normally be accepted by MMS for royalty determination purposes. * * * If the prices used to calculate royalties fall below this range, a minimum value that is acceptable to MMS can be determined by developing an average value from the lowest and highest prices in the range.

Id. at 6-7.

2/ With respect to the suggested location, the Procedure Paper cautions that "each valuation case should be separately evaluated to determine if an alternate location would be more pertinent than the suggested location" (Procedure Paper, Attachment 1).

The Procedure Paper also directs when to use the yardstick. If lessees have a true arm's-length contract which establishes an NGLP price, MMS will normally accept the arm's-length contract price for royalty purposes unless the gross proceeds received were higher than the contract price. Id. at 8. However, if there is no contract or the contract is not an arm's-length contract, the yardstick may come into play:

If lessees have a non-arm's-length contract which establishes an NGLP price and the lessee can demonstrate that the contract has characteristics similar to arm's-length contracts which represent fair market value, MMS will accept the non-arm's-length contract price for royalty computation purposes. If there are no arm's-length contracts for the same field or area, or the non-arm's-length contract does not represent fair market value, the yardstick value is considered fair market value. [Emphasis in original.]

Id. at 9. 3/

We note by way of background that section 18(a)(4) of the Outer Continental Shelf Lands Act (OCSLA), as amended, 43 U.S.C. § 1344(a)(4) (1988), states that "[l]easing activities shall be conducted to assure receipt of fair market value for the lands leased and the rights conveyed by the Federal Government." See Watt v. Energy Action Educational Foundation, 454 U.S. 151, 162 (1981). In addition, 30 CFR 206.152 (1985) provided at all relevant times that, where natural gas is processed for the recovery of its constituent components, royalty will accrue on the value of all residue gas remaining after processing and "[a]ll natural gasoline, butane, propane, or other substances extracted from the [nat-ural] gas." Departmental regulations defined the meaning of the "value of production," whether in the case of residue gas or liquid products resulting from the processing of natural gas:

The value of production shall never be less than the fair market value. * * * In establishing value, the Director shall consider: (a) The highest price paid for a part or for a majority of like-quality products produced from the field or area; (b) the price received by the lessee; (c) posted prices; (d) regulated prices; and (e) other relevant matters. Under no circumstances shall the value of production be less than the gross proceeds accruing to the lessee from the disposition of the produced substances or less than the value computed on the reasonable unit value established by the Secretary.

30 CFR 206.150 (1985). 4/ It is well established that, under the applicable statute and regulations, the Department has considerable discretion in

3/ The Procedure Paper also provides different rules for valuing production if it occurred during the period of control of prices by the U.S. Department of Energy. All of the production involved here occurred during the period of decontrol (January 1980 to the present) (Procedure Paper at 4).

4/ Effective Mar. 1, 1988, the Department completely revised the regulations in 30 CFR prescribing the proper method for valuing natural gas,

determining the value of production for purposes of royalty computation. Marathon Oil Co. v. United States, 604 F. Supp. 1375, 1382 (D. Alaska 1985), aff'd, 807 F.2d 759 (9th Cir. 1986), cert. denied, 480 U.S. 940 (1987); Amoco Production Co., 78 IBLA 93, 96, aff'd, Amoco Production Co. v. United States, No. 344-87-L (Cl. Ct. Aug. 7, 1989); Hoover & Bracken Energies, Inc., 52 IBLA 27, 33, 88 I.D. 7, 10 (1981), aff'd, Hoover & Bracken Energies, Inc. v. U.S. Department of the Interior, 723 F.2d 1488 (10th Cir. 1983), cert. denied, 469 U.S. 821 (1984).

[1] Appellant contends that establishment of interpretation by procedure paper, rather than regulation, violates its due process rights, asserting that MMS cannot require it to comply with that paper because it is a substantive rule of law which was required to be promulgated pursuant to the notice and comment rulemaking provisions of the Administrative Procedure Act (APA), 5 U.S.C. § 553 (1988). In the absence of proper promulgation, appellant argues, the Procedure Paper cannot be enforced.

We have previously held that the Procedure Paper was not required to be so promulgated because it does not constitute a substantive rule of law, as it neither creates law nor changes established policy. Rather, it simply clarifies the methodology for applying the factors set forth in 30 CFR 206.150 (1985). Conoco, Inc., 110 IBLA 232, 242-43 (1989), appeals filed, Conoco, Inc. v. United States, No. 643-89-L (Cl. Ct. Nov. 28, 1989), and Atlantic Richfield Co. v. Lujan, No. CA3-89-2393-G (N.D. Tex.). As the Director stated in his April 1988 decision, at page 3: "The procedure paper merely provides internal guidance for how [the] authority [under 30 CFR 206.150 (1985)] should be exercised." See Amoco Production Co., 112 IBLA 77, 81 (1989). The Procedure Paper is an interpretative rule precisely because, in the words of appellant, it "neither add[s] to, nor take[s] away from the statute or regulation" (Reply at 5). Appellant has offered nothing that persuades us to deviate from the conclusion that the Procedure Paper was not required to be promulgated pursuant to the notice and comment rulemaking provisions of the APA.

Appellant contends that the Regional Manager's January 1986 letter applying the Procedure Paper to the valuation of NGLP constituted a sud-den change in policy which violated appellant's due process rights and was arbitrary and capricious because it represented the first application of that policy to the valuation of appellant's NGLP without any explanation for the change. We reject these contentions.

[2] Concerning appellant's due process rights, it is significant that MMS could have arrived at the same interpretation through conventional case-by-case adjudication. 5/ Instead, by adopting its Procedure

fn. 4 (continued)

whether processed or unprocessed, for royalty computation purposes. 53 FR 1230 (Jan. 15, 1988).

5/ As the Director stated in his April 1988 decision, at page 4, "It is clear that even if the procedure paper did not exist, the Secretary could, in the exercise of his discretion, determine that royalty valuation should be based on prices set forth in commercial bulletins such as Mont Belvieu."

Paper, MMS merely clarified and standardized its interpretation of the NGLP valuation regulation. This practice of using agency-wide interpretative memoranda providing guidelines to agency decisionmakers has long been approved by the Bureau of Land Management. See, e.g., Beard Oil Co., 105 IBLA 285, 288 (1988). This Board is not bound to follow internal agency interpretative pronouncements such as the Procedure Paper. See Schweiker v. Hansen, 450 U.S. 785, 789 (1981); United States v. Kaycee Bentonite, 64 IBLA 183, 214 (1982). Thus, as we retain the authority to reverse any illegal agency action, even if it is consistent with an intra-agency interpretative statement such as the Procedure Paper, appellant's right to due process is protected by its right to appeal to this Board.

[3] Appellant contends that the Procedure Paper is inconsistent with the applicable statute and Departmental regulations and that MMS' reliance on it renders its actions arbitrary and capricious. In particular, appellant states that MMS violated the requirement in 30 CFR 206.150 (1985) that it consider all of the factors listed therein and that this failure renders MMS' actions arbitrary and capricious. The Procedure Paper reflects a consideration by MMS, albeit in a general context, of most of the enumerated factors. Compare, Lone Star Steel Co., 117 IBLA 96 (1990). MMS arrived at its conclusion that spot market prices constituted the best guide to NGLP fair market value based on a review of such posted prices, as well as sale contract prices, presumably for like-quality products, and regulated prices. Further, MMS did not entirely rule out the use of other factors. This entire process, thus, was designed to involve a consideration of all of the factors listed in 30 CFR 206.150 (1985).

Because spot market prices were not even mentioned as factors which MMS was entitled to consider under 30 CFR 206.150 (1985), appellant argues, MMS failed to abide by that regulation by relying on such prices. We have held that not to be the case. As we concluded in Conoco Inc., 110 IBLA at 241, consideration of spot market prices comported with the directive in 30 CFR 206.150 (1985) that MMS consider "posted prices" in valuing production. The Procedure Paper states only that spot market prices will "in most instances" be indicative of the fair market value of NGLP (Procedure Paper at 5). This language, therefore, does not preclude MMS from deciding in any given case that one of the other factors listed in 30 CFR 206.150 (1985) is more indicative of such value.

Appellant contends that MMS failed, in determining the royalty value of the subject NGLP, to consider other market conditions which affect NGLP prices, referring to "national and international economic and political conditions; the price of crude oil and refined products; supply and demand patterns within the industry; availability and choice of potential purchasers; pipeline connections and other transportation modes available; to name but a few" (SOR at 16). While there is no evidence that MMS directly considered such market factors, all of these factors would presumably be reflected in the prices, including the spot market prices, considered by MMS in the preparation of the Procedure Paper and the actual determination

of the royalty value of the subject NGLP. 6/ Appellant has not convinced us that other more relevant factors applied.

When MMS adopts an agency-wide interpretation that is reasonable and consistent with the law, the Board will not hesitate to affirm application of that interpretation. See Beard Oil Co., 105 IBLA at 288; Margaret A. Ruggerio, 34 IBLA 171 (1978). We conclude that the Procedure Paper comports with 30 CFR 206.150 (1985) and that MMS' reliance on it does not render its actions arbitrary and capricious.

Appellant also argues that MMS' decision to rely primarily on spot market prices, as set forth in the Procedure Paper, is akin to the Department's Notice to Lessees No. 4 (NTL-4), which was held to be contrary to the applicable statute, arbitrary and capricious, and an abuse of discretion because it departed from long-established Departmental policy not to charge royalties with respect to gas unavoidably lost and used in lease operations, which policy had been left unchanged despite repeated congressional reenactment of the statute. Marathon Oil Co. v. Andrus, 452 F. Supp. 548 (D. Wyo. 1978). 7/ We disagree. MMS' decision in the Procedure Paper to rely on spot market prices did not represent a significant change from prior policy comparable to the decision announced in NTL-4 to charge royalties on particular categories of gas at a time when the Department had long concluded that no royalties were due. As discussed above, the Procedure Paper merely constituted a decision to focus on one of the factors already set forth in 30 CFR 206.150 (1985) made only after a careful

6/ Appellant also challenges MMS' reliance on Mont Belvieu spot market prices, asserting that that market is "geographically remote" from the North Terrebonne gas processing plant where the subject NGLP were processed and actually sold and, thus, the "prices of liquids delivered to that market do not reflect the value of the liquids at the plant" (SOR at 16). While the relevance of the Mont Belvieu market to the value of NGLP coming from the North Terrebonne plant is an important consideration in determining the fair market value of those NGLP, appellant does not persuade us that that market is not properly considered. In Mobil Oil Corp., 112 IBLA 56, 61-62 (1989), we concluded that, although the locations are geographically distant, the question is whether the locations are economically distinct such that the NGLP processed at the North Terrebonne plant will fetch a far different price in the Mont Belvieu market, and that the appellant had failed to establish that fact. See also Union Oil Co., 111 IBLA 369, 371 n.1 (1989). That is situation here as well. 7/ In reaching that conclusion, the court relied in part on the fact that the Mineral Leasing Act had been amended without altering said long-term Departmental policy, holding that "re-enactment of a statute without amendment in the face of a consistent administrative construction is persuasive evidence of legislative recognition and approval of such construction." Id. at 551. In addition, the court relied on the general rule that "when the executive department charged with the execution of a statute gives a construction to it and acts upon that construction for many years, the Court looks with disfavor upon a change whereby parties who have contracted in good faith under the old construction may be injured by a different interpretation." Id.

review of the usefulness of most of the other regulatory factors for determining fair market value. It did not preclude consideration of such other factors in appropriate circumstances. As consideration of spot market prices was already embodied in the regulations, we cannot say that lessees could reasonably have presumed that spot market prices would not be used. Thus, we perceive no basis to conclude that lessees were unfairly harmed by the application of the new policy focussing on such prices. Finally, unlike in Marathon, we cannot say that Congress may be presumed to have approved any contrary operative policy to that approved in the Procedure Paper. Accordingly, we will not overturn the methodology adopted in the Procedure Paper on the basis that it fails to pass muster under the analysis enunciated in Marathon.

[4] Appellant also contends that the Procedure Paper should not be applied retroactively with respect to royalties paid prior to the date MMS properly advises lessees of its applicability, citing Continental Oil Co. v. United States, 184 F.2d 802, 821 (9th Cir. 1950) (SOR at 11). Thus, appellant argues that MMS is not entitled to require that royalties due prior to the Regional Manager's January 1986 letter be recalculated, thereby limiting the permissible effect of the Director's April 1988 decision to royalties due from January through April 1986 (SOR at 18).

It is undoubted that MMS has applied the Procedure Paper retroactively to the extent that MMS required appellant to recalculate royalties due for the period either prior to its issuance (December 1984) or prior to the time the policy was first applied to it (January 1986). The permissibility of applying the Procedure Paper depends on the balancing test set forth in Runnells v. Andrus, 484 F. Supp. 1234, 1237-38 (D. Utah 1980). 8/ Sun Exploration & Production Co., 112 IBLA 373, 392, 97 I.D. 1, 10 (1990). Applying this test, we conclude that the Procedure Paper may be given retroactive effect. As noted above, we do not consider that paper to have been an abrupt change in well-established practice, but instead to be a refinement and continuation of the regulation already in effect. 9/ See

8/ As set forth in Runnells, which involved an interpretative ruling made in the course of Departmental adjudication, the test essentially involves balancing the ill effects of a retroactive decision against the statutory purpose sought to be protected, considering whether the case is of first impression, whether the new rule is an abrupt departure from well-established practice or merely attempts to fill a void in an unsettled area of the law, the extent to which the party against whom the new rule is applied relied on the former rule, the degree of burden which a retroactive decision imposes on that party and the statutory interest in applying the new rule. See Retail Wholesale & Department Store Union v. NLRB, 466 F.2d 380, 389-90 (D.C. Cir. 1972). 9/ By contrast, Continental Oil involved a change from computing royalty on the basis of the value of residue gas and one-third of the gasoline derived from processing natural gas (with two-thirds of the gasoline deducted as the cost of manufacturing) to computing royalty on the basis of the higher of either that value or the gross field realization for both products less actual extraction costs. Similarly, in Sun Exploration, we concluded that MMS' adoption of a new accounting procedure that resulted

Richard F. Carnell (On Reconsideration), 76 IBLA 151, 157-59, 90 I.D. 432, 435-36 (1983). We have also found that there was no well-established practice at odds with the Procedure Paper at the time appellant paid the royalties involved herein upon which it could have relied. Even disregarding the above, we are not convinced that appellant has demonstrated that the ill effects of applying the policy retroactively outweigh the mischief which would be caused by not giving it retroactive effect. See Securities & Exchange Commission v. Chenery Corp., 332 U.S. 194, 203 (1947). Apply-ing the policy retroactively only ensures that appellant will pay the fair market value for NGLP produced from Federal lands, as required by section 18(a)(4) of OCSLA. As noted above, in view of the fact that the Department's regulations gave fair notice that royalty was due on the full value of NGLP, appellant has not demonstrated that requiring it to meet this royalty obligation will unfairly harm it.

Appellant contends that MMS should not use the yardstick method, but should simply accept the prices actually received for NGLP by its predecessor Aminoil. There are two distinct sets of circumstances here. From January 1984 to April 1985, appellant acknowledges that the sales contract in effect governing sales by Aminoil to AMI, a marketing affiliate, was not an arm's-length contract. After 1985, it is equally undisputed that the sales contract was at arm's length. To recap, under the Procedure Paper, in the case of an arm's-length contract, MMS will normally accept the contract price; in the case of a non-arm's-length contract, MMS will accept the contract price only if the lessee demonstrates that the non-arm's-length contract has characteristics similar to arm's-length con-tracts which represent fair market value (Procedure Paper at 8, 9).

[5] As to the non-arm's-length contract, appellant argues that the actual prices received should determine value for royalty purposes because MMS failed to demonstrate that such prices do not reflect fair market value (SOR at 17). Appellant asserts that the contract prices are reflective of fair market value and has submitted a July 8, 1982, agreement under which Aminoil agreed to sell to AMI all of its NGLP, with the exception of ethane, at a "fair market value price," and a May 15, 1984, agreement under which Aminoil agreed to sell to AMI all of its ethane produced at the North Terrebonne plant at AMI's actual sales price less 25 cents per gallon. 10/

fn. 9 (continued)

in a marked change in royalties owed from those calculated under the old accounting procedure previously accepted by the Department was an abrupt change in well-established practice. That is simply not the case here.

10/ Appellant states that the sales price in the contracts with AMI was established by subtracting "AMI's marketing fee and location differential" from "the [Mont] Belvieu average of Oil Price Information Service, Oil Buyer's Guide and BPN Propane News prices for the first week of the month." SOR at 16-17. Appellant explains that the location differential was intended to recognize the fact that Mont Belvieu "prices are not appli-cable to liquids which are located in a location remote from that market." Id. at 17. Nothing in the copies of the agreements between Aminoil and AMI indicates that this was the basis for the NGLP contract prices. Nevertheless, even assuming that it was, as we hold infra, in determining value for

In its additional SOR to the Director, at page 10, appellant indicated that it was attempting to "review arm's length sales of liquids for the same time period." However, apart from the contract provision baldly stating that the contract price was a "fair market value price," appellant did not submit any information regarding arm's-length contracts for NGLP in effect during the period from January 1984 to April 1985 so that they could be compared with the characteristics of Aminoil's non-arm's-length contract. Nor has appellant made any offer of proof specifying what such information might show. ^{11/} This failure blocks its efforts to avoid application of the yardstick.

In any event, Aminoil's non-arm's length contract price, even if accepted, would be properly adjusted to the extent that impermissible deductions were taken. Thus, in his April 1988 decision, at page 7, the Director properly rejected the use of appellant's non-arm's-length contract prices for the period from January 1984 to April 1985, because they were based on published prices "less a margin to recover Aminoil[s] * * * marketing costs." We have affirmed such rejection of such deduction in the past, as lessees are required to bear all of the costs of bringing the NGLP to market. 30 CFR 206.152(d) (1985); see Mobil Oil Corp., 112 IBLA 198, 209 (1989); Amoco Production Co., 112 IBLA at 87; Arco Oil & Gas Co., 112 IBLA 8, 10-12 (1989). In addition, appellant has indicated that its non-arm's-length contract prices were also reduced by a "location differential" which was designed to allow for the fact that these prices were taken from a distant market (Mont Belvieu). In the absence of any proof that the subject NGLP would command a different price in the Mont Belvieu market, deduction of such differential is not permitted. See Mobil Oil Corp., 112 IBLA at 62.

With respect to the period after April 1985, appellant contends that NGLP was sold pursuant to arm's-length contracts and, thus, that the actual prices received by appellant should be accepted by MMS. In effect, the Director accepted these contract prices, but disallowed impermissible deductions from them for royalty purposes. As with the contracts from the previous period, admitted adjustments to account for the marketing costs of the third-party purchasers and for a location differential are properly disallowed. The fact that a sales price is based on an arm's-length contract does not insulate that contract from review to determine whether it

fn. 10 (continued)

royalty purposes, appellant is not entitled to deduct from the Mont Belvieu prices the costs of marketing the NGLP or in order to account for the remote location of that market. We also note that AMI's use of Mont Belvieu prices to establish value for royalty purposes weakens appellant's assertion that it was arbitrary and capricious for MMS to do so.

^{11/} In Mobil Oil Corp., 112 IBLA at 63 n.8, we recognized that the burden of establishing the content of other arm's-length contracts is a difficult one, but that it comports with the option extended to lessees by the Board in Getty Oil Co., 51 IBLA 47, 51 (1980). As in Mobil, we would not rule out the possibility that appellant might convince MMS on remand that its contract had characteristics similar to arm's-length contracts that represent fair market value.

allows for impermissible deductions of value of production for royalty purposes.

Based on the foregoing, except as discussed below, we therefore affirm the Director's April 19, 1988, decision.

[6] Appellant contends that the average spot market price used by MMS to value production in accordance with the Procedure Paper when the price used by a lessee falls below the lowest spot market price is arbitrary and capricious and constitutes a penalty which is not authorized by section 109 of the Federal Oil and Gas Royalty Management Act of 1982, 30 U.S.C. § 1719 (1988). See SOR at 7-8, 12-13.

Although we do not agree that using the average spot market price constitutes a penalty (see Amoco Production Co., 112 IBLA at 87), we do agree that use of the average spot market price to establish the value of NGLP is improper where, as here, the actual lease price of the NGLP was less than the lowest spot market price. Mobil Oil Corp., 112 IBLA at 62-63; Conoco, Inc., 110 IBLA at 243-44. Accordingly, we conclude that the Director's April 1988 decision improperly affirmed the Regional Manager's April 1986 letter to the extent that it required appellant, in the course of recalculating royalties owed pursuant to the Procedure Paper, to use the average spot market price where the price actually received by appellant was less than the lowest spot market price. The proper price to use was the lowest spot market price. See Mobil Oil Corp., 112 IBLA at 63. We therefore set aside the Director's April 1988 decision. Upon receipt of the case, MMS should take further action consistent with this decision to instruct appellant regarding any necessary recalculation of the royalties owed with respect to NGLP produced and processed at the North Terrebonne gas processing plant from January 1984 through April 1986.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is affirmed in part, set aside in part, and remanded.

David L. Hughes
Administrative Judge

I concur:

John H. Kelly
Administrative Judge